

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Fixed Income –
Revised Fixed Income Policies

ITEM NUMBER: 11

ATTACHMENT(S): 3

ACTION: X

DATE OF MEETING: July 10, 2002

INFORMATION: _____

PRESENTER(S): Michelle Cunningham

EXECUTIVE SUMMARY

Last month, the Investment Committee adopted the Lehman Brothers' U.S. Aggregate Index (ex Tobacco) as the new performance benchmark for the Fund's internally managed investment grade fixed income assets, effective July 1, 2002. As a result, references to the fixed income performance benchmark within the policy manual have been updated to reflect this change. In addition, staff is submitting an increase in the daily trading authorization limits for the Principal Investment Officers and the Director of Fixed Income, given the opportunistic nature of the implementation strategy for this benchmark revision.

Staff also took this opportunity to review each of the two policy manuals for the fixed income portfolios, one of which was last updated in October 2000 (the Long-Term Fixed Income Portfolio Policy Manual), and the other in April 1999 (the Liquidity Portfolio Policy Manual), for any further necessary updates. Given the similarities between both sets of policies, staff is submitting a combined "Internally Managed Fixed Income Portfolios Policy Manual".

Attachment 1 represents a marked-up policy manual, illustrating staff's suggestions; **Attachment 2** is the proposed policy manual, as revised.

RECOMMENDATION

Staff recommends the following for the Investment Committee's consideration and approval:

- 1) That the Board approve the changes to the Internally Managed Fixed Income Portfolio Policy Manual to reflect the new performance benchmark, the updated trading authorization limits, and the combination of the previous two Policy Manuals (the Liquidity Portfolio Policy Manual and the Long-Term Fixed Income Portfolio Policy Manual) into one.
- 2) That the Board approve the attached Board Resolution (**Attachment 3**)

Date prepared: 6/26/02

By:

Paul Shantic
Paul Shantic
Principal Investment Officer

Michelle Cunningham for
Glenn Hosokawa
Principal Investment Officer

Michelle Cunningham
Michelle Cunningham
Director of Fixed Income

Review & Concur:

Christopher J. Ailman
Christopher J. Ailman
Chief Investment Officer

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

INTERNALLY MANAGED
~~LONG-TERM~~ FIXED INCOME
PORTFOLIO
Policies Policy Manual

INVESTMENT BRANCH
~~October 2000~~
July 2002

California State Teachers' Retirement System
~~Long-Term~~ Fixed Income Portfolio Policy Manual

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California State Teachers' Retirement System
Long-Term Fixed Income Portfolio Policy Manual

INTRODUCTION

Fixed income portfolios can be considered unique in that they represent an investment asset class that bridges the return and risk characteristics between cash equivalents and stocks. The California State Teachers' Retirement System's (CalSTRS; System) core long-term fixed income holdings play several important roles within the investment portfolio. These roles include providing diversification, a real rate of return, and cash flow/liquidity.

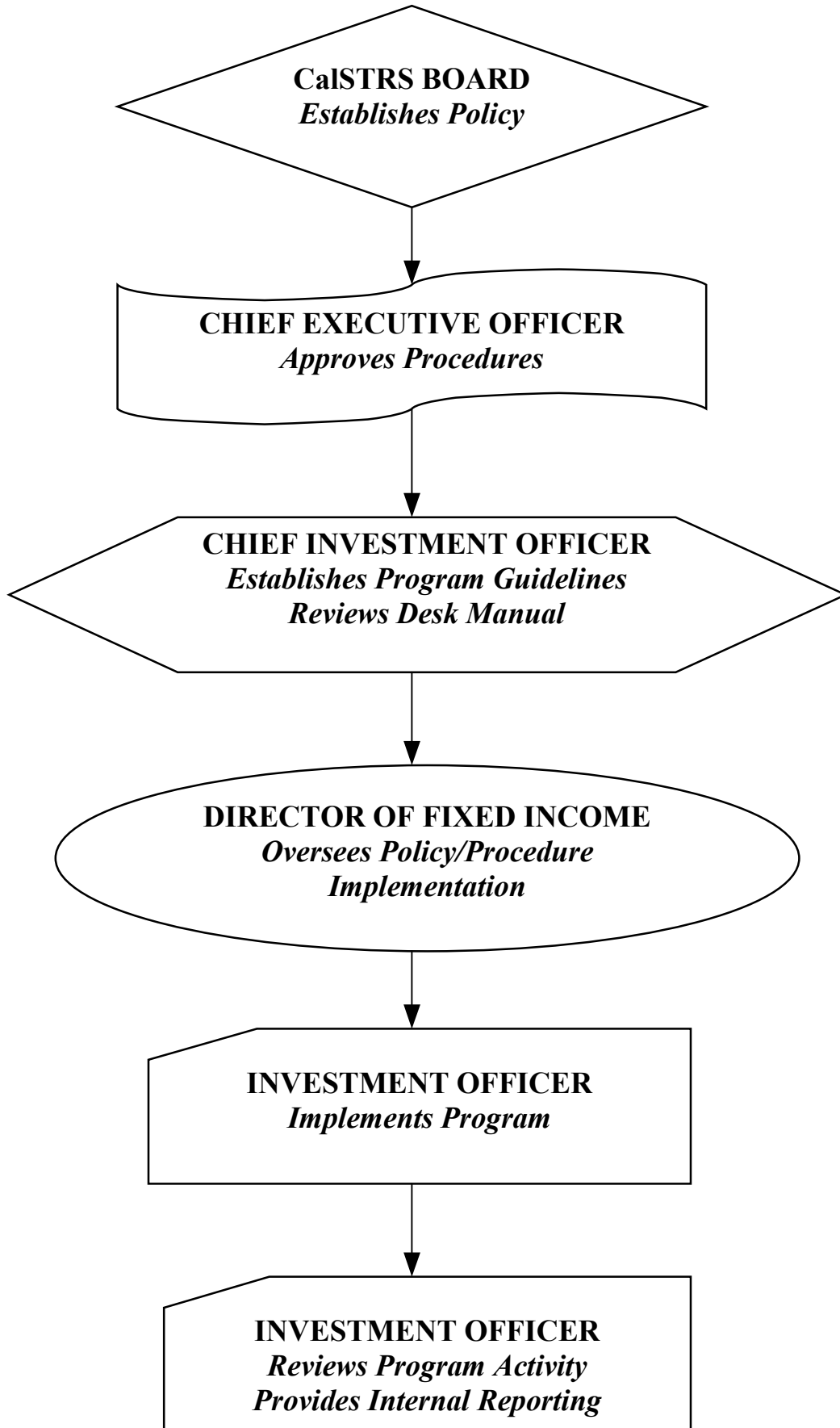
The long-term fixed income portfolios invest in a wide range of dollar-denominated securities, including, but not limited to:

- U.S. Treasury Bonds/Notes
- U.S. Agency Bonds/Notes
- U.S. Government Sponsored Corporations
- U.S. Corporate Bonds, Notes, and Medium Term Notes (publicly traded & privately placed)
- Mortgage Backed Securities (publicly traded & privately placed)
- Whole Loans
- Asset Backed Securities
- U.S. Dollar Bonds issued in the U.S. by foreign borrowers (Yankees)
- U.S. Dollar Bonds issued outside the U.S. (Eurobonds)

These fixed income securities are managed internally by Investment Officers – Fixed Income, under the direction of the Director of Fixed Income within the asset allocation and strategic objectives established by the California State Teachers' Retirement Board (Board).

This policy document outlines the approved policies of CalSTRS' internally managed long-term fixed income portfolios and has been designed to set the boundaries that will ensure prudence and care in the management of the fixed income portfolios while allowing sufficient flexibility in the management process to capture investment opportunities. A flow chart is included to provide the context for the policies within the general process of the management of the internally managed long-term fixed income portfolios. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.

LONG-TERM FIXED INCOME PORTFOLIO FLOWCHART



California State Teachers' Retirement System
~~Long-Term~~ Fixed Income Portfolio Policy Manual

PORTFOLIO POLICIES

~~October 2000~~ July 2002

The following *document* represents the approved policies to be utilized in the management of the internally managed ~~long-term~~ fixed income segment of the total investment portfolio. *It should be noted that the fixed income segment includes both long-term and short-term investments. The following policies will apply to both, unless otherwise noted.* These policies are designed to set boundaries that will ensure prudence and care in the management of the fixed income portfolios, while allowing sufficient flexibility in the management process to capture investment opportunities. Policies approved by the CalSTRS Board cannot be altered without explicit direction from the CalSTRS Board. *A flow chart is included to provide the context for the policies within the general process of implementing the internally managed Fixed Income Portfolio. Words and terms that may be unfamiliar to the reader are referenced in the Glossary.*

1. **Laws and Statutes** – The System's internally managed ~~long-term~~ fixed income assets are to be invested in a prudent manner for the sole benefit of its participants and beneficiaries in accordance with the California State Teachers' Retirement Law and other applicable statutes. No investment instrument or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, shall be authorized for the internally managed ~~long-term~~ fixed income portfolios.

2. **Investment Objectives** –

Long-term: The internally managed long-term fixed income assets shall be invested using an enhanced indexing investment strategy in which the strategic objective is to consistently exceed the total return of the performance benchmark with a similar risk profile. The performance benchmark for the internally managed long-term fixed income assets shall be the ~~Salomon Brothers Large Pension Fund Index (LPF Index)~~ *Lehman Brothers U.S. Aggregate Index (ex-Tobacco)*.

Short-term: The investment objective for the Liquidity Portfolio is to seek the preservation of capital and liquidity, and to generate the highest possible current income consistent with a prudent level of risk available from investing in a diversified portfolio of short-term fixed income securities

3. **Diversification** – Diversification within investment portfolios is critical in order to control risk and maximize returns. Minimum and maximum ranges with respect to investment sectors, credit exposure, and duration shall be established for the internally managed ~~long-term~~ fixed income portfolios within the context of the characteristics of the performance benchmark. Such ranges shall be documented within the Procedures Manual and are subject to change as conditions warrant, as determined by the Director of Fixed Income.

4. **Trade Execution** – Competitive bids/offers are encouraged for all portfolio transactions. However, there are circumstances which preclude the competitive process during trading. Such exceptions are to be documented on the trade ticket, and the statistics associated with trading activity included in the monthly ~~fixed income report~~ *reporting process*. The Investment Officers shall use their best efforts and discretion at all times to obtain the most favorable trade execution possible for the System.

5. **Authorized Signers** – Authorization letters, which indicate who may transact business for the CalSTRS internally managed ~~long-term~~ fixed income portfolios, shall be sent with a copy of the most recent Investment Resolution, initially at the time an account is opened, and then periodically to all fixed income broker/dealers with whom CalSTRS conducts business. Whenever a change in authorized signers takes place, the broker/dealers shall be notified in writing within 24 hours, in the event of termination, and as soon as possible in the event of a newly authorized signer(s).

6. **Authorization Limits** –

Long-term: The following daily limits apply with respect to the approval of trade activity within the internally managed long-term fixed income portfolios:

• Investment Officer I	\$25 million
• Investment Officer II	\$100 million
• Investment Officer III	\$250 million
• Principal Investment Officer	\$350 million \$500 million
• Director of Fixed Income	\$500 million \$750 million
• Chief Investment Officer	\$1 billion

Short-term: No daily limits with respect to the approval of trade activity within the Liquidity Portfolio shall be established.

7. **Trade Processing** - Prior to being processed to Operations, all trade tickets shall be authorized within the limits noted above and countersigned by two Investment Officers within Fixed Income.

8. **Business Plan** – The internally managed ~~long-term~~ fixed income portfolios will be managed in accordance with an annual Business Plan. This plan will include a broad overview of the asset class with the key issues associated with the management of the portfolios, as well as future objectives and a resource allocation study.

9. **Delegation of Authority** – The management of CalSTRS' internally managed ~~long-term~~ fixed income portfolios is delegated to staff within the boundaries established by these policies and the processes described within the Procedures Manual.

10. **Reporting** – ~~Staff will prepare a report~~ *In the monthly reporting process* for the Chief Investment Officer, ~~which staff will~~ summarize the activities associated with the management of the *internally managed* ~~long-term~~ fixed income portfolios ~~on a monthly~~

basis. The reports shall provide information regarding portfolio performance, risk characteristics ~~vs. the performance benchmark~~, and trade execution summaries.

11. **Board Review** – The Board shall administer and review this policy periodically, as it deems appropriate and in keeping with the investment standard.

ADOPTED BY THE TEACHERS' RETIREMENT BOARD ON JULY 8, 1993

REVISED ON JUNE 5, 1996

REVISED ON APRIL 7, 1999

REVISED ON OCTOBER 11, 2000

REVISED ON JULY 10, 2002

California State Teachers' Retirement System
~~Long-Term~~ Fixed Income Portfolio Policy Manual

GLOSSARY

AGENCY SECURITIES - Investments issued by federal corporations and federally sponsored corporations that are able to issue debt at a lower cost to such constituencies as farmers, homeowners, and students.

ASSET-BACKED SECURITIES - Investments that are collateralized by assets such as automobile loans, agricultural equipment loans, and credit card loans. The loans feature credit enhancements that lead to high credit ratings and limited investor exposure to the credit of the seller.

BANKERS' ACCEPTANCES - Time drafts drawn on and accepted by a bank within one to six months. They are used to provide manufacturers and exporters with capital to operate between the time of manufacturing (or exporting) and payment by purchasers.

BASIS POINT - One hundredth of one percent; .0001 in decimal form.

CASH FORECAST - The projection provided by CalSTRS' Operations division of the sources and uses of cash for the System in the immediate future.

CERTIFICATE OF DEPOSIT (CD) - A negotiable security issued by commercial banks against money deposited with them for a specified period of time. CDs pay interest at either a fixed or floating rate, periodically or at maturity, and the principal when it reaches final stated maturity.

COLLATERAL - Securities and other property pledged by a borrower to secure payment of a loan.

COMMERCIAL PAPER -Unsecured, short term (usually a maximum of nine months) bearer obligations with denominations in multiples of \$100,000.00, issued principally by industrial corporations and finance companies; usually issued at a discount from face value.

COMPETITIVE BIDS - The practice of soliciting more than one bid or offer for a security transaction. It is based on an identifiable asset in accordance with identified fixed rules for all participants.

CORPORATE BOND - A financial obligation for which the issuer, a company, promises to pay the bondholders a specified stream of cash flows, including periodic interest and a principal repayment.

CREDIT RATING - A relative ranking of timely interest payment and principal repayment based on past records of debt repayment, current financial status, and future outlook for the company.

DISCOUNT NOTE (AGENCY) - An obligation of a federal corporation or a federally sponsored corporation issued at a discount to par value, usually less than one year to maturity.

DURATION - The weighted average maturity of the present value of a bond's cash flow stream. A measure of the change in price for a small movement in interest rates.

EURODOLLAR DEPOSITS - Certificates of deposit issued by banks outside of the United States, with interest and principal paid in dollars.

FAILED TRADE - Purchased or sold investment securities that are not delivered on the contracted settlement date.

INDEX - A defined representative collection of securities used to measure the change in value of the securities market on a monthly basis.

INDEXED PORTFOLIO - Contains a core portfolio of United States Treasury issues, mortgage-backed securities, and corporate securities.

INVESTMENT OFFICER - Any one of the in-house investment professionals in the CalSTRS Fixed Income unit.

LIQUIDITY - The ease with which a bond can be purchased or sold at a fair price in a timely manner.

LIQUIDITY PORTFOLIO - For CalSTRS' purposes, this is the Short-Term Fixed Income Portfolio that provides cash flow for funding transactions for the System, such as benefit payments, investment manager activity, and asset allocation. Examples of short-term investments include U.S. Treasury, Agency, and money market securities (commercial paper, certificates of deposit, Eurodollar deposits, repurchase agreements).

MEDIUM TERM NOTE - Medium Term Notes (MTNs) are corporate or agency debentures. They differ from traditional underwritten corporate bonds only in the process by which they are issued. MTNs typically are offered on a periodic or continuous basis through one or more managers acting as agents.

MORTGAGED-BACKED SECURITY (MBS) - A security that is issued by a federal agency, such as the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association that is backed by mortgages. Payments to investors are received out of the interest and principal of the underlying mortgages.

MOTIVATION - The force, intent, or impulse that causes the Investment Officer to approach a transaction or series of transactions in a particular way.

PAR VALUE - The underlying stated value of a bond. The par value serves as the basis for calculating coupon payments and settlement details.

PORTFOLIO - A collection of stocks, bonds or money market securities owned by an investor and segmented by a predefined method.

POSITION - The status of securities, futures, and options in an account - long or short.

PRINCIPAL PAYDOWN - The portion of a periodic payment that reduces the amount of the principal.

PRIVATE PLACEMENT - The purchase of a security directly from the issuing corporation.

QUALITY RANGES - Guidelines for the percentage of market value of a particular credit rating within a portfolio.

RATE OF RETURN - The total income received over a period of time, including interest income, accretion of discount, amortization of premium and change of market value; usually expressed as a percentage or in decimal format.

REALIZED LOSS - The excess of a bond's book value on the date of sale over the sale's proceeds.

REPURCHASE AGREEMENT (REPO) - An arrangement or contract with a dealer to purchase a government, agency or other security at a fixed price, with provisions for its resale at the same price at a rate of interest determined competitively.

SETTLEMENT DATE - For each security transaction, a price is established based on the specifics of the security and the payment date. The payment date, or when the security is exchanged for value, is called the settlement date.

SHELF REGISTRATION - The maximum amount of a MTN issue.

SINKING FUND - The periodic retirement of a portion of a principal amount of a bond issue. A pre-specified schedule determines the timing and the amount of the sinking fund payments.

SPLIT-RATED - The credit ratings of corporate and other securities are made by independent services such as Moody's or Standard & Poors. When a security receives ratings that are different among the rating services, the term split-rated is used to signify this difference in relative credit ratings.

TRACKING ERROR - The deviation of the portfolio's rate of return from that of the target index or management criteria.

UNITED STATES TREASURY SECURITIES - Debt issues of the U.S. Government, such as Treasury bills, notes and bonds.

WHOLE LOANS - A secondary mortgage market term which refers to an investment in an original mortgage loan, versus a loan which participates in a secured pass-through security.

CalSTRS

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

INTERNALLY MANAGED FIXED INCOME PORTFOLIO *Policy Manual*

INVESTMENT BRANCH
July 2002

**California State Teachers' Retirement System
Fixed Income Portfolio Policy Manual**

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California State Teachers' Retirement System
Fixed Income Portfolio Policy Manual

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July 2002

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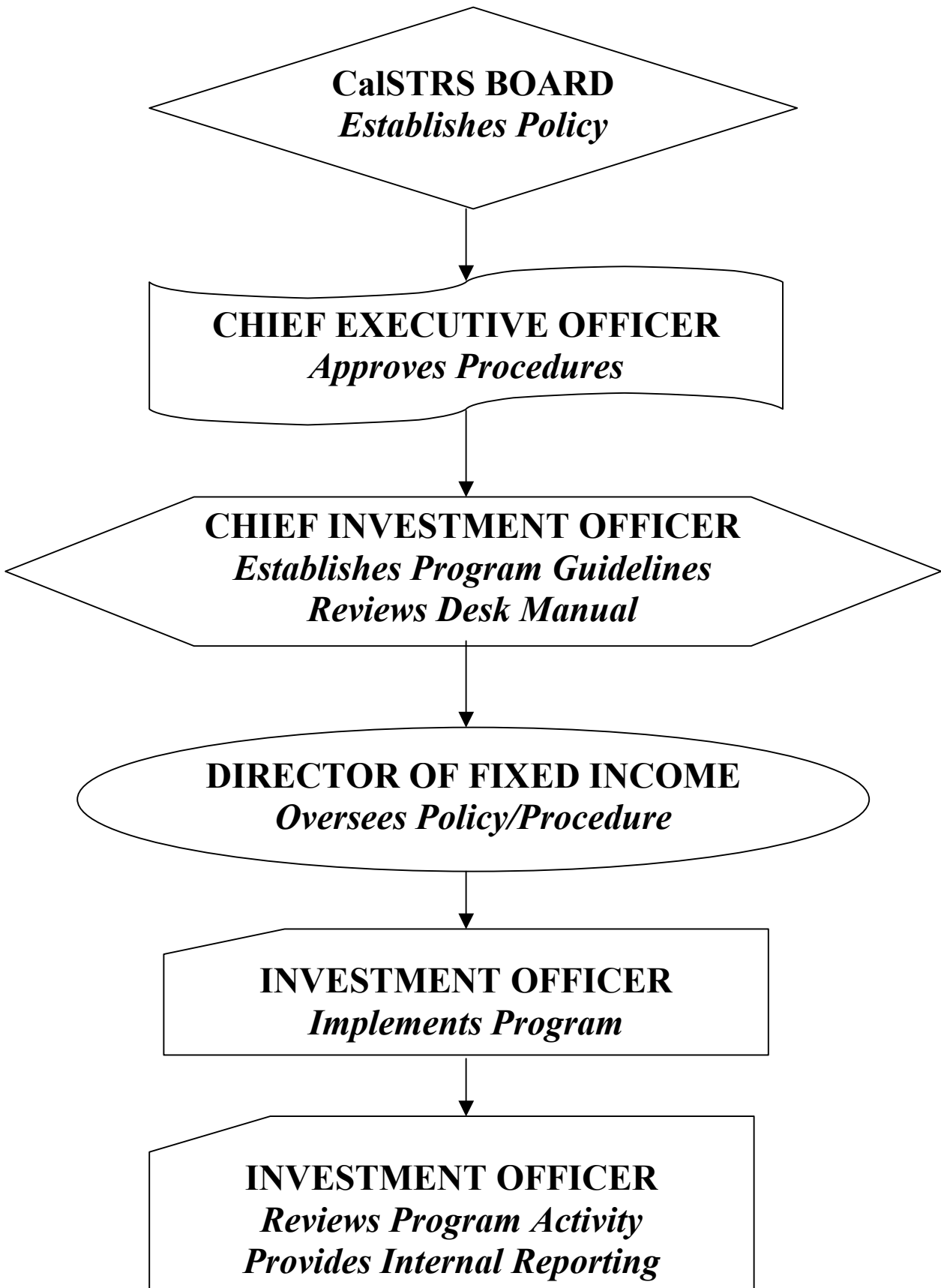
REVISED ON APRIL 7, 1999

REVISED ON OCTOBER 11, 2000

REVISED ON JULY 10, 2002

California State Teachers' Retirement System
Fixed Income Portfolio Policy Manual

FLOWCHART



California State Teachers' Retirement System
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PROPOSED
RESOLUTION OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Fixed Income – Revised Fixed Income Policies

Resolution No. _____

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the Investment Committee has received and reviewed the Internally Managed Fixed Income Portfolio Policies and has heard oral presentations from Staff; and

WHEREAS, the Staff has recommended the adoption of the Internally Managed Fixed Income Portfolio Policies; Therefore be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board adopts the Internally Managed Fixed Income Portfolio Policies.

Adopted by:
Investment Committee
on July 10, 2002

Jack Ehnes
Chief Executive Officer